Colorado State University Extension
Agriculture & Business Management Notes...

Crop Share Lease Arrangements for Colorado's Farms and Ranches

Jenny Beiermann, Norman Dalsted, Jeffrey E. Tranel, and R. Brent Young[1]

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Land is an expensive resource for agricultural producers. A large capital investment is required to purchase enough land, or land of sufficient quality, to provide the farm family an opportunity to earn a satisfactory living. New and beginning farmers may not be able to afford the purchase of farmland. They may not have enough capital, income may be insufficient to meet debt repayment obligations, they may not have the credentials (including equity) to obtain debt, or the risks may be greater than the possible rewards.

Leasing (renting) is one option for gaining control of farmland. A lease is a business agreement between the tenant farmer and the landowner. It provides the basis for combining the landlord's and the tenant's resources of land, labor, capital, and management to efficiently produce farm commodities. It gives the use of an asset to a lessee for a specific period of time, for specific uses, at a specified rate. A lease does not transfer title of ownership nor an equity interest in the asset.

One type of lease arrangement pertaining to crop land is called a "crop share" lease. Crop share lease agreements provide for a specified percentage of the harvested crop to go to each the landowner and the tenant. The basic premise is for each party to receive income from the crop in proportion to what each party contributes to the costs of production.

In a typical crop share lease agreement, the landowner contributes land and improvements, associated property expenses, and a certain share of the variable costs. The tenant usually contributes machinery, associated equipment expenses, and a certain share of the variable costs. If irrigation water is involved, the landowner typically pays any assessment (ownership) fees, provides any pumping equipment, and pays for major pump and well repairs. The tenant usually pays a portion of minor repairs for the pump and for pumping costs such as diesel fuel, electricity, or natural gas.

Advantages of a crop share lease agreement over other types of lease agreements include:

1. Less operating capital may be needed by the tenant due to the landowner sharing some production costs.
2. Management may be shared between an experienced landowner and tenant resulting in more effective and financially rewarding decisions.
3. Crop shares and input purchases may be timed for improved income tax management.
4. Risks of low yields and prices are shared between the two parties. Profits from high yields and/or prices are also shared.

[1] Beiermann, Tranel, and Young are Agricultural and Business Management Economists with Colorado State University Extension and faculty affiliates with the Department of Agricultural and Resource Economics. Dalsted is a Professor and Agricultural and Business Management Economist in Colorado State University's Department of Agricultural and Resource Economics and Extension. Beiermann can be contacted at jenny.beiermann@colostate.edu.

5. The landowner may more easily prove "material participation" for involvement in government programs, estate planning purposes, building social security base, and income tax purposes.

Disadvantages of crop share lease agreements include:

1. Landowner income will vary due to yield and price variations as well as changes in costs of shared production inputs.
2. Accounting for shared expenses must be maintained.
3. The landowner must make decisions about marketing and crop insurance coverage.
4. The landowner and tenant must discuss and agree to annual cropping practices and management decisions.

Developing a Fair Crop Share Lease Agreement

Farming is a business in which land, labor, and capital are combined through the application of management. Where each of these factors are owned and/or contributed by different parties, the payment for each factor should be equal to their value as an input to production. The lease should address two primary issues: (1) how should the crop be shared? and (2) how should the cost of inputs be shared?

Valuing land is difficult. Land costs represent a high proportion of total costs, and land usually appreciates in value over time. Land values should be based on fair market value for agricultural purposes with adjustments made for property taxes and insurance. Buildings and improvements should be evaluated on their contributions to the farming operation. Sometimes a separate cash rent is charged for the buildings.

Machinery and equipment normally have a multi-year life, so their cost should be spread over several years. Contributions are often based on depreciation, taxes, insurance, repairs, housing, and some return on the investment. Custom rates for anticipated operations are sometimes used when machinery and equipment costs are unknown.

Management is an important contribution to a successful lease arrangement. Its value is often a bargaining proposition between the involved parties. Management may be valued as a percentage of gross returns, rate per unit of yield, or percentage of all non-land costs.

Variable expenses should be shared according to their nature – yield increasing, true substitution, or both. Variable expenses which are yield increasing should be shared in the same percentage as the crop share. Such sharing encourages the parties to use the amount of the input which maximizes net returns to the total operation.

Substitution inputs are those that replace another input, such as chemical weed control replacing cultivation. New technologies may make substitution inputs available to the production process. Substitution inputs may cause yields to increase and/or be used to replace a currently used input. True substitution items should be shared in the same percentage as the crop share.

Irrigation costs may involve special problems and include the water, mechanism for distribution of the water (sprinkler, flood, etc.), and labor. The landowner and tenant should be careful when agreeing to which party will pay for which irrigation expenses.

Government program payments are usually shared in the same proportion as the crop. Crop insurance is typically carried by both parties, thus, the landowner and tenant will receive the associated payments for each policy. In those situations where there is "set aside" land, the tenant normally pays the costs of tillage, weed control, and other necessary land management. Given that government programs and crop insurance policies change over time, the lease agreement should include language identifying who – the landowner and/or the tenant – pays any costs and receives payments for being involved in government programs or purchasing crop insurance.

It should be recognized that factors other than the relative contributions to production costs may affect rental agreements. Crop share percentages tend to be accepted as customary for a particular area; hence they are not easily changed. Also, local supply and demand conditions for rented land may affect the agreement.

Put the Agreement in Writing

It is highly desirable to put the terms of any crop share rental agreement in writing. A written lease agreement enhances understanding and communication between all involved parties, serves as a reminder of the terms agreed to, and provides a valuable guide for the heirs if either the landowner or the tenant dies. Further, a written lease may be required by a creditor, for involvement in government programs, or to purchase crop insurance.

Every lease should include certain items – the names of the parties involved, an accurate description of the property being rented, beginning and ending dates of the agreement, amount of rent being paid and when and how it is to be paid, conditions of termination, and the signatures of the parties involved. Furthermore, other provisions (such as the rights and responsibilities of both parties) should be included in the written lease.

Labeling a document as a lease does not necessarily mean it is a lease according to the Internal Revenue Service (IRS). Questions concerning the IRS treatment of a lease should be addressed by your tax management professional. Also, the legalities of the lease should be addressed by professional legal counsel.

Colorado State University's ABM Team has created and made available a spreadsheet template for evaluating the fairness of alternative crop share lease agreements. The template and other information about crop, pasture, and building lease agreements are available from CSU Extension on the Agricultural and Business Management web site. (www.coopext.colostate.edu/ABM/).